Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:WAS:POSTF-144937-01
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date: February 27, 2002

to: [redacted], Team Coordinator, Internal Revenue Service

from: Associate Area Counsel (LMSB)
(Heavy Manufacturing, and Transportation)
Washington, D.C.

subject: [redacted] - Interest Expense

This is in response to your request for advice regarding the inclusion of liabilities when determining a foreign corporation's amount of interest expense under Internal Revenue Code section 882. This advice addresses the requirements under Treasury Regulations section 1.882-5. This memorandum should not be cited as precedent.

DISCLOSURE STATEMENT

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THIS ADVICE IS NOT BINDING ON EXAMINATION OR APPEALS AND IS NOT A FINAL CASE DETERMINATION. THIS ADVICE IS ADVISORY AND DOES NOT RESOLVE THE POSITION OF THE INTERNAL REVENUE SERVICE ON AN ISSUE OR PROVIDE THE BASIS FOR CLOSING A CASE. THE DETERMINATION OF THE INTERNAL REVENUE SERVICE IN THE CASE IS TO BE MADE THROUGH THE EXERCISE OF THE INDEPENDENT JUDGMENT OF THE OFFICE WITH JURISDICTION OVER THE CASE.

ISSUE

1. Did [redacted] improperly exclude liabilities in determining the amount of interest expense allowed under Internal Revenue Code section 882?

FACTS

[redacted] (Taxpayer) is a [redacted] corporation doing business in the United States (U.S.). Taxpayer filed a

U.S. Income Tax Return of a Foreign Corporation (Form 1120F) for the year at issue. Taxpayer is an accrual method taxpayer with an October 31 year end. Taxpayer was audited by the Internal Revenue Service (Service) for the years ending [redacted], [redacted], and [redacted]. On [redacted], Taxpayer made an advance payment for all three (3) tax years in the form of a cash bond. In September of [redacted], the Service issued a Revenue Agent Report (RAR) regarding the deficiencies. Taxpayer signed the RAR and on [redacted] Taxpayer made an additional advance payment in the form of a bond. On [redacted] the Service assessed the following deficiencies:

For the tax year ending October 31, [redacted] - $[redacted]
For the tax year ending October 31, [redacted] - $[redacted]
For the tax year ending October 31, [redacted] - $[redacted].

Taxpayer's advance payments included payment for the interest on the deficiency amounts. The interest was calculated from the due date of the tax return for each of the three tax years at issue (from January 15, [redacted] for the tax year ending October 31, [redacted]; from January 15, [redacted] for the tax year ending October 31, [redacted]; and from January 15, [redacted] for the tax year ending October 31, [redacted]).

For the tax year ending October 31, [redacted], Taxpayer claimed an interest expense deduction of $[redacted] related to the above tax deficiencies.[1] The interest expense deduction included the interest paid on the Federal, state, and local tax deficiencies for the tax years [redacted], [redacted], and [redacted]. Taxpayer calculated the amount of the interest expense deduction using the interest expense calculation provided by the Treasury Regulations in effect for the year at issue, Treasury Regulations section 1.882-5. Taxpayer, however, in determining the amount of its interest expense did not include the underlying tax deficiencies as liabilities.

LAW

Section 882 of the Internal Revenue Code provides, in part, that foreign corporations engaged in a trade or business within the United States (U.S.) will be subject to tax on income that is

[1] Taxpayer claimed $[redacted] in total interest expense on its Form 1120F for the tax year ending October 31, [redacted]. For purposes of this memorandum only the amount of interest expense related to the tax deficiencies is at issue. Unless otherwise indicated all amounts used in this memorandum are based upon information provided by the Taxpayer.

effectively connected with a U.S. trade or business. I.R.C. § 882(a)(1). Foreign corporations paying tax on effectively connected U.S. income are allowed to take into account deductions and credits in determining the amount of income. I.R.C. § 882(c)(1). Deductions, however, are allowed;

> only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the United States; and the proper apportionment and allocation of the deductions for this purpose shall be determined as provided in regulations prescribed by the Secretary. *Id.*

Pursuant to section 882, the Secretary issued regulations providing a process for determining the proper amount of an interest deduction. Treas. Reg. § 1.882-5, 46 Fed. Reg. 1681 (Jan. 7, 1981).[2] Treasury Regulations section 1.882-5(a)(1) provided that: "The classification of items as assets or liabilities must be on a consistent basis from year to year and substantially in accordance with U.S. tax principles." Treasury Regulations section 1.882-5(a)(6) provided the Commissioner the authority to make adjustments to reflect the substance of a transaction:

> (6) *Adjustments to reflect substance.* If the substance of a loan or other transaction differs from its form, the Commissioner or his delegate may make appropriate adjustments to reflect the transaction in accordance with its substance.

Treasury Regulations section 1.882-5(a) provided, in part, "[t]he interest deduction allowed a foreign corporation under section 882(c) is determined by the three-step process set forth in paragraph (b) of this section." Section 1.882-5(b) provided, in part, the following three-step process to be used in determining the interest deduction allowed to a foreign

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[2] Treasury Regulations section 1.882-5 was amended March 8, 1996, effective for tax years beginning on or after June 6, 1996. 61 Fed. Reg. 9326 (March 8, 1996), as corrected 61 Fed. Reg. 15,891 (April 10, 1996). Taxpayer's tax year at issue in this case began November 1, [redacted] Therefore, the amended regulations do not apply. All references and citations to Treasury Regulations section 1.882-5 refer to the regulations effective prior to June 6, 1996. The amendments to the regulations would not affect the result in this matter.

corporation with respect to its effectively connected gross income:

> (1) *Step 1 -- Asset determination.* The average total value of all assets of the corporation that generate, have generated, or could reasonably have been or be expected to generate income, gain, or loss effectively connected with the conduct of a trade or business in the United States must be determined for the taxable year (or applicable portion thereof). This average total value must be stated in U.S. dollars.
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> (2) *Step 2 -- Liability determination.* The amount of liabilities of the corporation connected with the conduct of a trade or business in the United States must be determined for the taxable year (or portion thereof). This amount of U.S.-connected liabilities is determined by multiplying the asset value determined under Step 1 by one of the following two ratios:
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> > (i) *Fixed ratio.* In the case of a U.S. banking, financing, or similar business (as defined in § 1.864-4(c)(5)(i)), ninety-five percent; in the case of any other U.S. business, fifty percent, or
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> > (ii) *Actual ratio.* The ratio of the average total amount of corporate worldwide liabilities (including those of the U.S. trade or business) for the year (or portion thereof) to the average total value of corporate worldwide assets (including those of the U.S. trade or business) for the year (or portion thereof). For purposes of computing this ratio, all liability amounts and asset values must be consistently stated from year to year either in U.S. dollars or in the currency of the country in which the head office of the corporation is located.
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> (3) *Step 3 -- Interest deduction allowed.* On the corporation's return for the first taxable year (or portion thereof) to which this section applies, the corporation must elect to use, for determining the amount of its allowed interest deduction, either the branch book/dollar pool method set forth in paragraph (b)(3)(i) of this section or the separate currency pools method set forth in paragraph (b)(3)(ii) of this section. Once made, the election may not be changed for

> later taxable years (except as provided in this paragraph (b)(3)) without the consent of the Commissioner or his delegate. For its first taxable year beginning after 1980, a corporation may change methods without obtaining the consent of the Commissioner or his delegate.
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> > (i) *Branch book/dollar pool method.* (A) If the amount of U.S.-connected liabilities, determined under Step 2, does not exceed the average total amount of liabilities (in all currencies) shown on the books of the U.S. trade or business (stated in U.S. dollars), the interest expense allowed to the foreign corporation as effectively connected with the conduct of a trade or business in the United States is determined by multiplying the average total amount of U.S.-connected liabilities for the year by the average U.S.-connected interest rate. The average U.S.-connected interest rate is equal to the ratio of the total amount of interest expense shown on the books of the U.S. trade or business for the year (or portion thereof) to the average total amount of liabilities shown on the books of the U.S. trade or business for the year (or portion thereof). Both the numerator and denominator of this ratio must be stated in U.S. dollars.
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Federal income taxes are due on the time and place fixed for filing the tax return. I.R.C. § 6151. The interest on tax deficiencies is calculated from the date prescribed for payment until the date paid. I.R.C. § 6601(a). From the date the return is to be filed, until the date the deficiency is actually assessed, a taxpayer has a positive obligation to the United States, a duty to pay its tax. Manning v. Seeley Tube and Box Co., 338 U.S. 561, 565 (1950). A valid debt or liability exists when a tax deficiency is determined. United States v. National Bank of Commerce, 472 U.S. 713, 719 (1985).

DISCUSSION

I. Did Taxpayer improperly exclude liabilities in determining the amount of interest expense allowed under Internal Revenue Code section 882?

Section 882 and its regulations were designed to allocate the interest expenses of foreign corporations between U.S. and foreign source income. 46 Fed. Reg. 1681 (January 7, 1981). This is accomplished by determining the value of the corporation's U.S. assets and the amount of the liabilities connected to those assets. Treas. Reg. § 1.882-5. The first step of the process under section 1.882-5 is to determine the value of U.S. assets that generate U.S. income. Taxpayer's determination of the value of its U.S. assets is not at issue.

The second step is for the foreign corporation to determine its U.S. connected liabilities by multiplying its U.S. assets by a certain ratio of assets to liabilities. Treas. Reg. § 1.882-5(b)(2). The corporation has the option of choosing between a fixed ratio specified by the regulations or the actual ratio of worldwide liabilities to worldwide assets. *Id.* Taxpayer elected to use the fixed ratio for the year at issue. Taxpayer's use of the fixed ratio is not at issue.

The third and final step under Treasury Regulations section 1.882-5 is to determine the interest allocable to the U.S.-connected liabilities by using one of two methods, the branch book/dollar pool method or the separate currency pools method. Taxpayer elected the branch book/dollar method. Under the branch book/dollar method the interest expense allowed is determined by multiplying the total amount of U.S.-connected liabilities by the average U.S.-connected interest rate. Treas. Reg. § 1.882-5(b)(3)(i). The average U.S.-connected interest rate is the ratio of the total amount of interest expense shown on the books of the U.S. trade or business to the total amount of liabilities on the books of the U.S. trade or business. *Id.* Taxpayer failed to include its tax liabilities in determining its U.S.-connected liabilities and in determining the average U.S.-connected interest rate. This resulted in a difference in the average U.S.-connected interest rate of approximately 64 basis points.

The regulations require Taxpayer to include all U.S.-connected liabilities when calculating its U.S.-connected liabilities and its average U.S.-connected interest rate. Treas.

Reg. § 1.882-5(b)(3)(i). By using the branch book/dollar pool method without accounting for the underlying liabilities, Taxpayer was able to increase its interest expense deduction dollar for dollar by the amount paid in interest. As a result, the amount of allowed interest expense deduction was increased by $[redacted]. If the liabilities were accounted for, the amount of interest expense ($[redacted]) would be reduced by approximately $[redacted].

Taxpayer has indicated that it did not include the amount of its tax deficiencies as part of its U.S.-connected liabilities because the tax deficiencies only existed for a brief period of time. Prior to assessment or the issuance of the RAR, taxpayer had posted a cash bond for the majority of the amounts of the deficiencies on [redacted]. On [redacted] after receiving and signing the RAR, Taxpayer immediately posted an additional bond for the remaining amount of the deficiencies. Taxpayer contends that its liabilities for the tax deficiencies existed only from the time it received notice of those deficiencies and signed the RAR until it posted the second cash bond, approximately one day. Taxpayer also contends that because the liabilities only existed for that brief period of time, Taxpayer's liabilities for the tax deficiencies need not be booked or taken into account for purposes of determining its U.S.-connected liabilities under the regulations.

Taxpayer's position is without basis. Federal taxes are due on the date the return is to be filed. I.R.C. § 6151. In the present case, Taxpayer's taxes were due on January 15 of the year following the year in which each deficiency was assessed ([redacted] and [redacted]). Tax deficiencies are determined from the date the return is due until the date the deficiency is paid. I.R.C. § 6601(a). Taxpayer's tax deficiencies existed from the due date of the returns until Taxpayer made a payment in the form of a cash bond on [redacted]. A valid, enforceable liability existed at all times during this period. *See* Manning v. Seeley Tube and Box Co., 338 U.S. 561, 565 (1950); United States v. National Bank of Commerce, 472 U.S. 713, 719 (1985).

Taxpayer failed to place the tax deficiencies as liabilities on its books. Taxpayer's failure to book the liabilities, however, does not affect the treatment or classification of the liabilities for tax purposes. Taxpayer is required to classify assets and liabilities in accordance with U.S. tax principles. Treas. Reg. § 1.882-5(a)(1). The form of the transaction must reflect the substance of the transaction, if not the Commissioner is authorized to make appropriate adjustments. Treas. Reg. § 1.882-5(a)(6). The principle amount of the liabilities existed from the due date of the respective returns. Because the tax liabilities were properly accruable under U.S. tax principles beginning on the due dates of the returns and the interest began running on those dates, the only amount that is properly accruable for the taxable year ending October 31, [redacted], is the amount that accrued on the balance of the deficiencies during that year. Any amount that is reflected on Taxpayer's books for [redacted] must reflect the amount that was properly accrued under U.S. tax principles for that year. The Service is authorized to make appropriate adjustments. Treas. Reg. § 1.882-5(a)(6).

CONCLUSION

Tax deficiencies are liabilities that exist from the date the return is due until paid. The regulations require all "U.S.-connected liabilities" to be included in determining the interest expense allowed to a foreign corporation. In this case, not only are Taxpayer's tax debts enforceable U.S.-connected liabilities, they are the liabilities that actually created the interest expense being claimed. Section 882 was designed to properly allocate the interest expense to the liability that created the expense. Omitting the liability that created the expense in determining where to allocate the expense would undermine the structure of section 882. The regulations require Taxpayer to properly classify assets and liabilities according to U.S. tax principles. Taxpayer is required to include its tax deficiencies in determining its allowable interest expense under section 882. The regulations also allow the Service to make any adjustments necessary to accurately reflect the substance of the transaction.

This advisory has been reviewed by the National Office and their views have been incorporated herein. If you have any questions regarding this matter, please contact Kristopher K. Baumann, the attorney in this office, responsible for this matter at (202) 634-5403, ext. (b)(6).

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